Principles for Responsible Investment

An investor initiative in partnership with
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Does reduced risk of investing in corporate social responsibility lead to lower returns?

Review of Lee, D. D. and R. W. Faff. (2009) "Corporate sustainability performance and idiosyncratic risk: A global perspective." The Financial Review, 44 (2): 213-237.

Review by Robert Kropp.
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Using the Dow Jones Sustainability Index (DJSI) as its corporate social performance (CSP) proxy, authors Darren D. Lee and Robert W. Faff argue "one of the main benefits of having a leading CSP profile is that a firm is able to reduce its business risk relative to lagging CSP firms and secure a lower cost of equity capital."

According to the authors, this does not necessarily translate into an increased rate of return for investors, because "lower risk equates to lower expected returns." In fact, in contrast to much research addressing the link between CSP and corporate financial performance (CFP), the authors find "a leading CSP portfolio underperforms its lagging counterpart." A negative relationship between CSP and CFP, however, might not indicate a loss of shareholder value as much as a price premium on the stocks of leading CSR firms. The authors conclude that idiosyncratic risk may indeed be "priced by the market, despite asset pricing models failing to predict their importance", since "leading CSP firms exhibit significantly lower idiosyncratic risk than lagging CSP firms." The authors argue higher returns for lagging CSP firms compensate for higher idiosyncratic risk. The evidence, suggest the authors, indicates investors wish to be compensated for increased risk; those who invest in leading CSP firms do so with the understanding decreased risk may lead to lower returns.